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SUBJECT: POLAND'S EURO ADOPTION A DISTANT PROSPECT

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SUMMARY

11. (SBU) Begin Summary. Poland has not yet set a target date for Eurozone entry even though it must eventually adopt the Euro. The Euro convergence issue, however, is being actively debated among economists and politicians in Poland. Bankers, as expected, support fast Euro adoption, while most GOP representatives prefer to take time and do their homework in order to fulfill the Maastricht criteria and prepare the legislative framework. Newly confirmed Prime Minister Jaroslaw Kaczinski did not discuss Euro adoption while outlining his priorities. In light of the current political situation, a realistic date for Euro convergence in Poland is 2012 at the earliest. (End Summary).

Background information

12. (U) Poland, in ratifying the EU Accession Treaty, committed itself to eventually becoming a full member of the EMU (European Monetary Union) and adopting the Euro. While the other EU-10 countries have set target dates for meeting the necessary economic provisions, Poland does not have a set timeline or plan for Eurozone entry. Recently appointed Minister of Finance Stanislaw Kluza stated that he expects Poland will fulfill the Maastricht criteria

by 2009 and begin discussions on Euro adoption. He recently stated that "Giving a date neither speeds up nor slows down the date for entering the Eurozone - however, a missed target date, like in the case of Hungary, can undermine confidence in the economic policy of a country."

13. (U) While adopting the Euro has advantages and disadvantages, studies done by Polish authorities including the National Bank of Poland and the Finance Ministry, and international organizations suggest that Poland would gain substantially from joining the Eurozone. Some economists argue that now, while the economy is growing at an annual rate of nearly five percent, is the best time to join. Others believe that it is necessary to further develop and stabilize the economy before moving forward with the Euro. There is consensus, however, that as long as there is no GOP commitment to enter the Eurozone at a pre-determined date, there will be no motivation or pressure on the government to take the steps necessary to fulfill the Maastricht criteria. Public support for Euro adoption is slowly increasing, but many Poles are afraid of the potential for abuse and cheating on prices during the changeover.

Poland is close to meeting the Maastricht Criteria

14. (U) Poland is close to meeting all of the Maastricht criteria, including inflation rate, long-term interest rates, fiscal deficit, public debt and exchange rate stability. For instance, Poland has been meeting the inflation standard since early 2003, with a short break caused by the price adjustment related to EU accession in 2004. This criterion requires that inflation be no more than 1.5 percentage points higher than the average of three EU member states with lowest inflation, or approximately 2.7% at present. Poland's inflation rate of 1.4% is significantly below the standard.

15. (U) The interest rate criterion states that long term interest rates, or rates of return on 10-year bonds, cannot be more than two percentage points higher than the average long term interest rates of the three EU member countries with the lowest inflation rates. Poland's long term interest rates are currently at 5.0%, below the 5.9% limit as determined by the standard.

16. (U) Strict fiscal rules contained in the Polish constitution guarantee fulfillment of the debt criterion, even though debt levels have been rising (41.9 % in 2004 and 42.5% in 2005). What will be most difficult to realize is the 3 percent limit on the general government deficit. In 2005, abnormally strong budget revenues allowed the criterion to be met (2.9%). The Ministry of Finance, in its updated Convergence Program 2006-2008 published in January 2006, confirmed that it expects a steady reduction of fiscal deficits in the upcoming years. The update assumes continued special treatment of Open Pension Funds when calculating the deficit. In 1999, Poland created open pension funds and placed them in the private sector, making Poland's long run fiscal position better than that of some existing members of the Eurozone, but inflated the budget deficit in the short run. Without continued special treatment of the funds, the government deficit will exceed 3 percent of GDP.

Poland Vis a Vis Other Visegrad (V4) Countries

17. (U) Poland's current status in fulfilling the Maastricht Criteria is often compared to that of the other three Visegrad countries: the Czech Republic, Slovakia and Hungary. While none of the V4 countries have met all of the Maastricht criteria, Poland is behind the rest in its planning for currency convergence. Slovakia was admitted into the ERM II in November 2005, while Hungary is the V4 country that has met the fewest of the Maastricht criteria at the present time. Nonetheless, all of the EU-10 nations with the exception of Poland have set target dates for Euro adoption.

CASE-BRE Euro Convergence Seminar

18. (U) A Euro convergence seminar sponsored by the Center for

Social and Economic Studies (CASE) and BRE bank was recently held in Warsaw. Panelists included Jaroslaw Pietras, Secretary of State in the Ministry of Finance, Jerzy Pruski, First Deputy President of the National Bank of Poland and Maciej Krzak, the chief economist of commercial bank Societe Generale. Since Poland is expected to eventually join the Eurozone, the panelists' presentations and the discussion that followed revolved around when the Euro should be adopted rather than if. Although each panelist offered a different perspective on the issue, Pruski and Krzak generally agreed that more timely Eurozone entry would be better for Poland's continued economic development while GOP representative Pietras voiced several legislative obstacles and potential drawbacks to rapid entry.

¶9. (U) All participants agreed that Poland could potentially benefit by becoming a full member of the EMU, but stressed the importance of choosing the right moment for entering to maximize the benefits. They argued that if Poland used the Euro, businesses will be more willing to trade and to carry out transactions in Poland due to lower costs, thereby increasing efficiency. There is also evidence that joining the Eurozone will increase foreign direct investment. Most importantly, Polish investors will gain better access to Euro capital markets and benefit from the increased transparency of the financial system.

Three Points of View: Central Bank, Commercial Bank and GOP

¶10. (U) Jerzy Pruski offered the Polish National Bank perspective that Poland should strive to adopt the Euro as quickly as possible. He pointed out that international trade would increase as a result of Eurozone entry, which would boost economic growth and development. In addition, any potential adverse effects to Poland's economy would be small due to its high level of integration with the rest of the EU. Pruski believes that Poland should attempt to begin its participation in the ERM II soon, in order to take advantage of the current favorable macroeconomic situation. He argues that Poland is experiencing the best configuration of macroeconomic parameters since 1998: GDP is at its potential, inflation is low, the current account deficit is at its historically lowest level, and there is external, and to a great extent, internal equilibrium. Pruski is convinced that postponing the decision on the Euro means wasting an opportunity that may not reappear.

¶11. (U) Maciej Krzak from Societe Generale also argued for quick adherence to the Maastricht criteria and timely entry into the monetary union. He emphasized that Poland should adopt the Euro at approximately the same time as its neighbors -- particularly the other three V4 countries. Krzak saw this aspect of timing to be the most crucial in terms of keeping Poland competitive and low-risk in the eyes of investors. He argued that if other V4 countries adopt the Euro first, outside businesses and investors may choose to go there instead of Poland, taking economic development with them.

¶12. (U) Jaroslaw Pietras of the Finance Ministry maintained that Poland is not yet ready for Euro convergence. He pointed out the need to align legislation related to monetary and exchange-rate management, including a change in the constitution. He also mentioned drawbacks to entry into the EMU such as the loss of control over monetary policy and possible higher levels of inflation. He enumerated the nation's priorities as economic growth and social solidarity. While the Finance Ministry recognizes potential benefits of the common currency, Pietras stated that Euro adoption is a major technical and logistical challenge affecting all sectors of society and hence requires a well designed plan and sound institutional backing. He also pointed out that non-Euro zone economies currently are experiencing a faster rate of growth than the EMU member states, a fact Poland - which is still catching up to the EU-15 - cannot afford to disregard. Nonetheless, he stated that the government hopes to meet the convergence criteria during the current Parliament's term (which ends in 2009) and that a convergence timeline will most likely be established when the criteria are met.

Comment

¶13. (SBU) When the ruling Law and Justice party won the 2005 parliamentary elections, it declared that Euro adoption was not a priority. PiS politicians continue to maintain this position and it is our opinion that the decision on targeting a date for Eurozone entry is unlikely to be made before the next parliamentary elections in 2009. Thus, the earliest date for Polish Euro adoption would be ¶2012. The divergence of views on Euro adoption in Poland polarizes both economists and politicians. Even within institutions that support Euro adoption, such as the National Bank, there are credible voices that are opposed to the move. While most economists agree that Euro adoption will eventually benefit the economy, most politicians and the public will need to be convinced. Until a target date is set, it is unlikely that the Ministry of Finance will take the necessary political and legislative steps to allow Euro adoption. Thus, Polish Euro convergence policy, like most other economic policy, will continue to drift

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